

Securities Trust of Scotland

Unconstrained approach driving outperformance

Securities Trust of Scotland (STS) aims to achieve rising income and long-term capital growth from a concentrated portfolio of large- and mid-cap global equities. Following the move to a higher-yielding and progressive dividend policy in May 2015, from 1 June 2016 STS adopted a new unconstrained, high-conviction investment approach under new manager Mark Whitehead. Performance is now measured versus a peer group of both open and closed-ended funds and in September 2016 gearing was increased from £17m to £25m. The changes appear to be bearing fruit – STS has outperformed its peer group benchmark since the change in investment approach in June 2016.

12 months ending	Share price (%)	NAV (%)	Blended benchmark (%)	FTSE All-Share (%)	MSCI World (%)
31/01/13	22.0	19.9	18.2	16.3	16.1
31/01/14	4.8	5.8	8.2	10.1	12.6
31/01/15	1.7	12.0	16.2	7.1	17.7
31/01/16	(2.5)	(1.9)	1.0	(4.6)	1.1
31/01/17	34.4	26.7	29.1	20.1	32.8

Source: Thomson Datastream. Note: All % on a total return basis in GBP. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

Investment strategy: High-conviction approach

Manager Mark Whitehead is able to draw on the resources of Martin Currie's income team, which he leads, to select a balanced portfolio of 35-55 global equities with rising income and the potential for long-term capital growth. The investment approach is unconstrained; companies are selected for their high-quality attributes such as sustainable sales growth, high free cash flow conversion and attractive valuations. The manager also undertakes credit analysis and stress-testing of a company's cash flow. STS's income is supplemented by limited use of options. Net gearing of 20% is permitted – at end-January 2017 it was 9.9%.

Market outlook: Valuations look full

2016 was a very strong year for both UK and global equity returns; sterling investors in global equities benefited significantly from sterling weakness. As a result, both UK and world equity valuations as measured by forward P/E multiples are c 20% above their 10-year averages. For investors wanting exposure to global equities, a fund aiming to provide growing income and long-term capital growth, which has undergone significant changes over the last two years, may appeal.

Valuation: Narrower near-term discount

STS's current 4.4% share price discount to cum-income NAV compares to the one-, three-, five- and 10-year averages of 6.0%, 4.5%, 1.6% and 3.8% respectively. There is scope for the discount to narrow further, or return to a premium, if STS's relative performance versus the peer group continues to improve. STS adopted a higher-yielding and progressive dividend policy in 2015 – the FY16 annual dividend increased 18.4% versus the prior year and its current dividend yield is 3.4%.

Investment trusts

24 February 2017

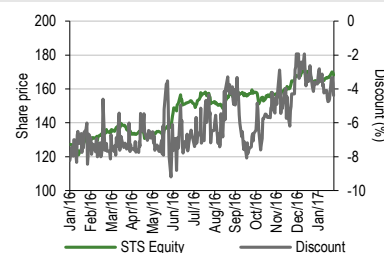
Price 168.3p
Market cap £189m
AUM £212m

NAV* 174.1p
Discount to NAV 3.4%
NAV** 176.0p
Discount to NAV 4.4%

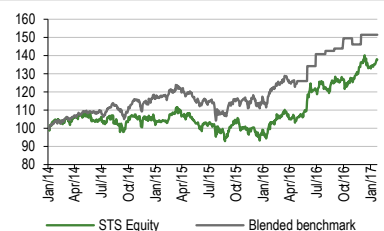
*Excluding income. **Including income. As at 22 February 2017.

Yield 3.4%
Ordinary shares in issue 112.2m
Code STS
Primary exchange LSE
AIC sector Global Equity Income

Share price/discount performance



Three-year performance vs index



52-week high/low 172.8p 127.8p
NAV** high/low 176.2p 139.5p

**Including income.

Gearing

Gross* 13.3%
Net* 9.9%

*As at 31 January 2017.

Analysts

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[Edison profile page](#)

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Exhibit 1: Trust at a glance

Investment objective and fund background

Securities Trust of Scotland's investment objective is to provide rising income and long-term capital growth through a portfolio of global equities. Following the adoption of an unconstrained mandate, from 1 June 2016 the trust measures its performance versus the rolling three-year median return of open- and closed-ended peers, as well as an absolute target to produce real growth in revenue and cum-income NAV on a rolling five-year basis.

Recent developments

- 17 January 2017: Announcement of third interim dividend of 1.45p.
- 18 November 2016: Interim results for six months ending 30 September 2016. NAV TR +13.7% versus peer group TR +14.2%. Share price TR +17.6%.
- 14 November 2016: Announcement of second interim dividend of 1.45p.
- 22 September 2016: Structural gearing increased from £17m to £25m – £10m two-year revolving credit facility and £15m seven-year fixed facility.

Forthcoming

AGM	July 2017
Final results	May 2017
Year end	31 March
Dividend paid	Quarterly
Launch date	28 June 2005
Continuation vote	None

Capital structure

Ongoing charges	1.0%
Net gearing	9.9%
Annual mgmt fee	0.6% of net assets
Performance fee	None
Trust life	Indefinite
Loan facilities	£25m (see page 7)

Fund details

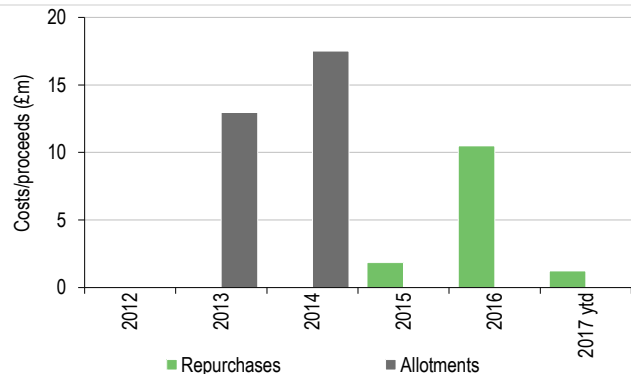
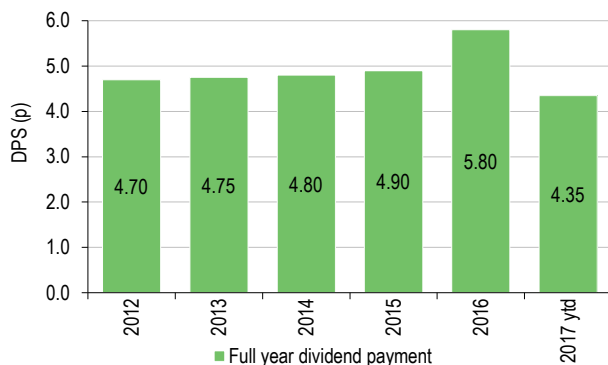
Group	Martin Currie Investment Mgmt (UK)
Manager	Mark Whitehead
Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Phone	+44 (0) 131 229 5252
Website	www.securitiestrust.com

Dividend policy and history (financial years)

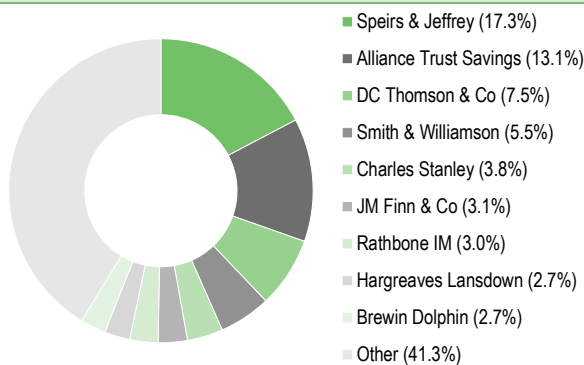
Dividends paid quarterly in September, December, March and June. Dividends were increased substantially for FY16 after the announcement of a new progressive dividend policy.

Share buyback policy and history (financial years)

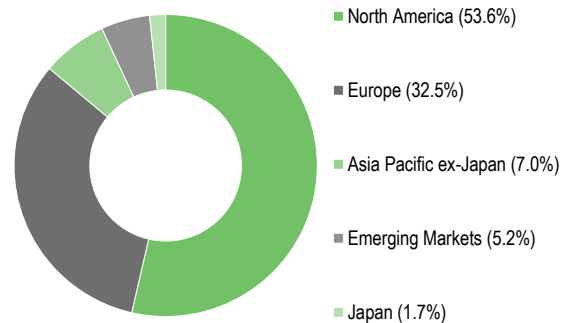
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 1 February 2017)



Portfolio exposure by geography (as at 31 January 2017, net of cash/gearing)



Top 10 holdings (as at 31 January 2017)

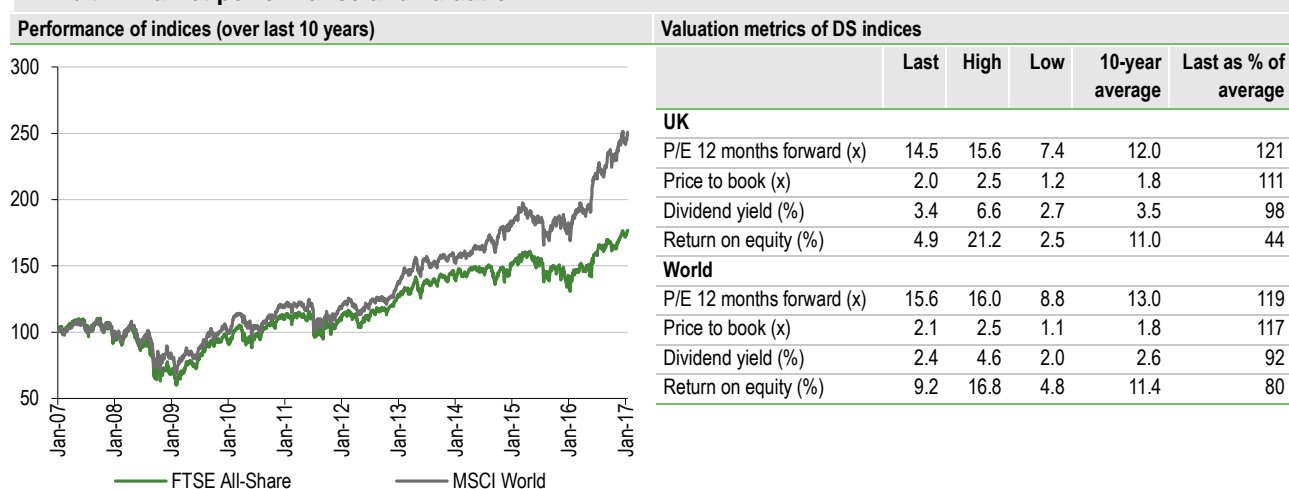
Company	Country	Sector	Portfolio weight %	
			31 January 2017	31 January 2016*
Chevron	US	Energy	3.9	4.2
Time Warner	US	Consumer discretionary	3.5	N/A
Roche	Switzerland	Healthcare	3.3	3.5
Apple	US	Information technology	3.3	N/A
Philip Morris International	US	Consumer staples	3.2	4.4
Waste Management	US	Industrials	3.1	N/A
Cinemark	US	Consumer discretionary	3.0	N/A
Verizon Communications	US	Telecommunication services	2.9	3.2
Eaton	US	Industrials	2.8	N/A
Huntington Bancshares	US	Financials	2.8	N/A
Top 10			31.8	37.8

Source: Securities Trust of Scotland, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in January 2016 top 10.

Market outlook: Valuations looking somewhat extended

Exhibit 2 (left-hand side) shows the performance of the FTSE All-Share and MSCI World indices in sterling terms over the last 10 years. Both indices rallied sharply over the last year, with the MSCI World index benefiting from sterling weakness. As a result, valuations are looking somewhat extended (Exhibit 2, right-hand side). The forward P/E multiple of the Datastream UK index is now 21% above the average of the last 10 years, while the Datastream world index is 19% above average. Although bond yields have moved off their lows, global interest rates remain low versus history. For investors looking for exposure to global equities, a fund providing growing income and long-term capital growth, which has undergone significant changes – leading to a visible improvement in its short-term performance – may be of interest.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Edison Investment Research

Fund profile: Income and growth from global equities

STS aims to generate rising income and long-term capital growth from a balanced portfolio of large- and mid-cap global equities. Since 11 May 2016, STS has been managed by Mark Whitehead, who joined Martin Currie as head of the income team. STS's portfolio is relatively concentrated, typically containing 35-55 holdings; the maximum permitted single stock holding is 7%. On 1 June 2016, STS changed its benchmark from the MSCI World High Dividend Yield index and moved to an unconstrained strategy measured against the median of its peer group over a rolling three-year period. The peer group is defined as the AIC Global Equity Income sector plus the actively managed open-ended funds from the Lipper Global Equity Income sector. The board believes that this peer group measurement gives customers a better view of how STS is performing versus its peers. There is also an absolute target of real growth in revenue and cum-income NAV over a rolling five-year period. Net gearing of up to 20% is permitted.

The fund manager: Mark Whitehead

The manager's view: More modest equity returns in 2017

Macro conditions at the start of 2016 suggested a year of subdued equity returns – concerns included slowing growth in China, weak commodity prices and the upcoming Brexit vote. Fast forward 12 months and sterling investors had a year of exceptional equity returns. Commodity

prices are higher, the Chinese authorities have intervened to reflate the economy and economic growth is stronger in both the US and Europe, leading to higher bond yields and a steeper yield curve. There are now signs of positive earnings revisions in the developed world; if Q416 earnings follow the improvement in Q316, the manager believes this will be the first back-to-back improvement in quite some time.

Following the unexpected outcome of the US election, equities have rallied sharply on the prospect of lower taxes, less regulation and higher infrastructure spending. The manager considers that equities have rallied a long way and are “priced for perfection” across a range of valuation metrics. Equity prices are not discounting any policy missteps and there are upcoming elections in France, Germany and the Netherlands, which creates further political risk. Pricing in the impact of Brexit is very difficult and higher newsflow surrounding the UK’s departure from the EU will likely increase stock market volatility. The manager says that the signs for earnings are positive, and at current levels, equities can grow into their valuations; however, equity returns in 2017 are unlikely to be a repeat of 2016.

Whitehead suggests that huge style shifts in 2016 have been difficult for active fund managers to navigate. Cyclical stocks such as financials, especially banks, have rallied significantly. He says that the cyclical trade may continue but needs to be underpinned by higher earnings; he considers that materials, financials, industrials and maybe energy stocks are looking overbought. There is now better value in some of the higher-quality names such as consumer staples, which have sold off aggressively – stocks such as Nestlé and Unilever are now cheaper than they were a few months ago. In the US, in Q416 the S&P 500 financial sector rallied by 20.5%, while the real estate sector fell by 5.3%. The manager suggests that the “elastic band” has been stretched a long way and there is the potential for real estate stocks to rally and financials to fall. Overall, he expects calmer sector moves in the stock market and a more level playing field in 2017.

Asset allocation

Investment process: Focus on quality income

The key element of the investment process is the search for income growth rather than just dividend yield. Companies considered for investment have sustainable sales growth, high cash flow conversion, efficient capital allocation and trade below their assessed intrinsic value. Company meetings form a key part of the investment process and management teams’ track records are assessed, including their corporate governance histories. The unconstrained investment process allows the manager to invest in what he considers to be the best companies across the globe. Since the appointment of Mark Whitehead in May 2016, the investment process has been enhanced, and now includes the use of credit analysis and stress testing the cash flow of current and potential investments, and limited use of options to supplement dividend income.

The manager is able to draw on the resources of Martin Currie’s income team, which was formed in November 2015 as an expression of the firm’s commitment to its income products. The team comprises four portfolio managers and three specialist income analysts; all team members undertake company research. Investments may be sold when they hit their assessed target price, if the original buy thesis is brought into question or there is a better investment opportunity available. In addition, if a stock declines 20% from its purchase price, it will automatically be reviewed and action may be taken. In 2016, portfolio turnover was c 40%, which is higher than a more typical 35% and was the result of adopting the new, higher-conviction investment approach at the beginning of June 2016.

STS invests in a blend of companies; some have lower dividends with potential for faster growth and some are higher-yielding companies. Every stock in the portfolio contributes to STS’s income –

the highest contributor is c 4% of total income with the lowest at c 1%. All portfolio companies are held for their strong income growth and potential for capital return.

Current portfolio positioning

At end-January 2017, STS's top 10 positions comprised 31.8% of the portfolio, which was a lower concentration than 37.8% at end-January 2016; four names were common to both periods.

Dividend growth for portfolio companies has been strong, including positions introduced into the portfolio more recently. In Q416, examples of companies increasing their quarterly dividends include Apple (+9.6%) and US regional bank Huntington Bancshares (+14.3%). Over the last year the largest changes in sector exposure are increases in materials (+4.4pp) and energy (3.9pp) and decreases in consumer staples (-7.3pp) and healthcare (-7.0pp). STS has been selling some large-cap companies such as pharmaceutical company Novartis, where the manager is concerned about industry pricing pressure. There has been negative rhetoric from US president Donald Trump, who has vowed to bring down drug prices. As a result the manager suggests that the healthcare industry is in transition and pricing pressure will continue.

Exhibit 3: Portfolio sector exposure (% unless stated)			
	Portfolio end-January 2017	Portfolio end-January 2016	Change (pp)
Financials	16.1	22.0	-5.9
Industrials	12.0	13.3	-1.3
Healthcare	10.9	17.9	-7.0
Information technology	10.7	3.0	7.7
Consumer staples	9.7	17.0	-7.3
Consumer discretionary	9.2	8.5	0.7
Energy	9.1	5.2	3.9
Materials	9.1	4.7	4.4
Real estate*	9.0	0.0	9.0
Telecommunications	8.1	8.7	-0.6
Utilities	5.4	9.6	-4.2
Cash	3.4	0.7	2.7
Active options exposure	0.6	0.0	0.6
Gearing	-13.3	-10.6	-2.7
	100.0	100.0	

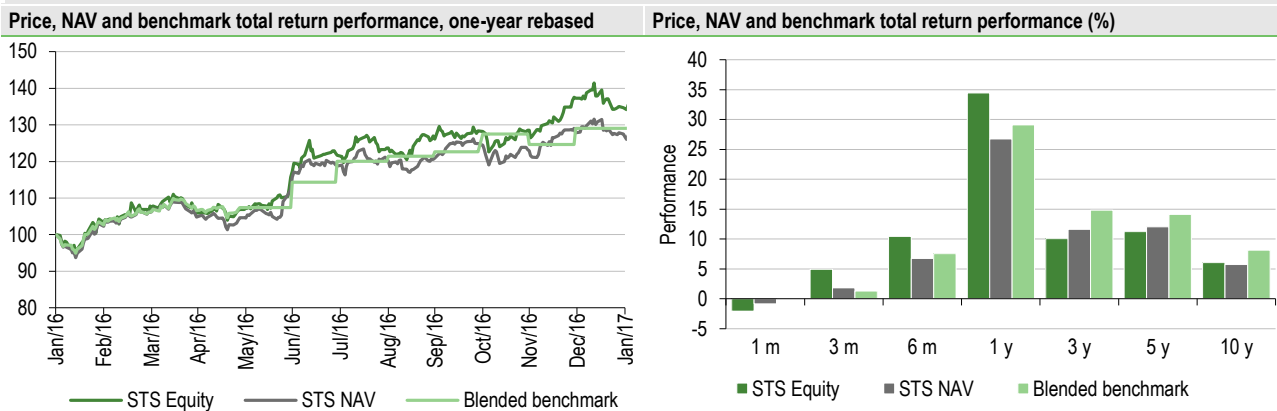
Source: Securities Trust of Scotland, Edison Investment Research. Note: *Real estate was part of the financial sector in January 2016.

The manager highlights that the unconstrained approach allows investments to be made in smaller companies and different types of assets such as private equity, infrastructure and collectives; examples include Apax Global Alpha and Civitas. With a market cap of c £700m, Apax Global Alpha is a collective closed-end fund run by Apax Partners, which has been investing in private equity for more than 40 years. It has c 100 investment professionals and more than £35bn AUM globally in unquoted/quoted investments. Apax invests in long-term trends that STS likes, such as healthcare (where demand is growing due to demographic changes), technology and changing consumer trends, such as Auto Trader in the UK, which has done very well for Apax over the last year. Apax Global Alpha has a target internal rate of return of 12% pa and a c 5.0% dividend yield; the position was bought at a c 15% discount to NAV, which has now started to close.

Civitas Social Housing has a market cap of c £350m and came to market in November 2016. It buys properties from developers, generally housing associations, which have debt on their balance sheets so have to sell on their portfolios to fund further development. There is a massive demand in the UK for social housing, such as assisted living, which has to be fit for purpose and demand is high due to an aging population. The rent that Civitas receives is primarily from tenants on housing benefit, so the rent is inflation protected. Civitas has an 8-10% internal rate of return pa and a target dividend yield of 5%. The manager considers that there is a lot of upside in the stock and that the company can grow into a nascent market. The Civitas position is an example of STS using its higher level of gearing to invest in a company with strong cash flows and the potential for higher income and long-term capital growth.

Performance: Improving near-term performance

Exhibit 4: Investment trust performance to 31 January 2017



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

Looking at STS's relative returns in Exhibit 5, its NAV total return trails the blended benchmark (details of which are highlighted in the note below Exhibit 4) over one, three, five and 10 years, although its share price has outperformed over one year. As shown in Exhibit 6, STS has outperformed the peer group benchmark since the change to an unconstrained, high-conviction investment approach on 1 June 2016. The manager states that changes to the investment process have led to more robust stock selection, which has been borne out by better short-term performance. Recent positive contributors to returns include Italian financial Banca Generali, which has experienced strong asset inflows and has benefited from lower country risk following a new Italian government; and Chevron, a major US oil company, which rallied following announced production cuts from both OPEC and non-OPEC oil producers. As a reference for sterling investors, STS's NAV total returns are ahead of the FTSE All-Share index over one, three, five and 10 years.

Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to blended benchmark	(2.1)	3.6	2.7	4.2	(12.0)	(12.0)	(17.9)
NAV relative to blended benchmark	(0.9)	0.6	(0.7)	(1.8)	(8.1)	(8.9)	(20.3)
Price relative to FTSE All-Share	(1.8)	1.9	3.0	12.0	8.7	8.5	4.7
NAV relative to FTSE All-Share	(0.5)	(1.1)	(0.5)	5.6	13.5	12.4	1.6
Price relative to MSCI World	(2.7)	1.5	(0.5)	1.2	(15.7)	(17.5)	(25.9)
NAV relative to MSCI World	(1.5)	(1.5)	(3.8)	(4.6)	(12.0)	(14.5)	(28.1)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-January 2017. Geometric calculation.

Exhibit 6: NAV total return performance relative to benchmark over three years



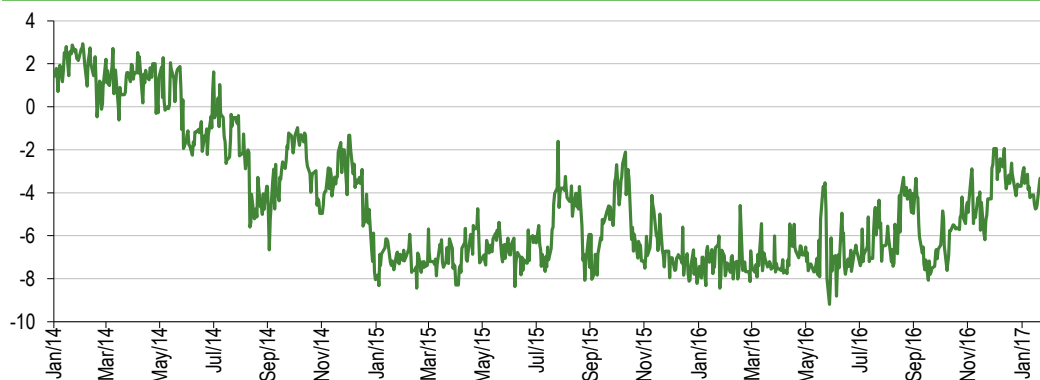
Source: Thomson Datastream, Edison Investment Research

Discount: Near-term narrowing trend

STS's current 4.4% share price discount to cum-income NAV is in a near-term narrowing trend; it is narrower than the average 6.0% discount of the last 12 months (range of 1.9% to 9.2%). It compares to the averages of the last three, five and 10 years of 4.5%, 1.6% and 3.8% respectively. Over the last 12 months the widest discount of 9.2% occurred on 27 June following the Brexit vote, which led to a general increase in investment trust discounts. There is scope for STS's discount to narrow further, or return to a premium, if the relative performance of the trust improves further.

STS operates a discount management policy, aiming to keep the average discount below 7.5% during the last 12 weeks of its financial year. In addition there are ad hoc share repurchases; so far in FY17, 0.89m shares have been repurchased at a cost of £1.22m.

Exhibit 7: Share price premium/discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

STS is a conventional investment trust with one class of share; there are currently 112.2m ordinary shares in issue. In September 2016, STS increased its structural gearing from £17m to £25m. It now has a £10m two-year revolving credit facility and has locked in low interest rates with a £15m seven-year fixed facility with Royal Bank of Scotland. The all-in fixed rates are: £1.50m at 2.1408%, €4.50m at 1.4175% and \$12.75m at 3.1925%. At end-January 2017, STS's net gearing was 9.9% (versus a maximum permitted level of 20%).

Martin Currie is paid an annual management fee of 0.6% of net assets. It is split 65:35 between capital and income; this is the board's expected long-term split of returns between capital gains and income. There is no performance fee. In FY16, the ongoing charge was 1.0%, which was in line with the prior year.

Dividend policy and record

STS adopted a new progressive dividend policy in May 2015, aiming to bring its dividend yield more in line with the peer group. The FY16 annual dividend of 5.80p was an 18.4% increase versus FY15. Dividends are paid quarterly in September, December, March and June. Under the new policy, dividends may be paid out of capital; the board considers this is a more attractive option than the manager investing in higher-yielding equities, where the level of dividend may be at risk. In FY16, the revenue return was 4.73p, meaning that the dividend was 82% covered by income. Based on the current share price, STS's dividend yield is 3.4%.

Peer group comparison

While STS now defines its benchmark as the rolling three-year median of open and closed-ended peers, in Exhibit 8 we compare it to the closed-end peers in the AIC Global Equity Income sector, with the understanding that the nine peers have different mandates. STS trails the peer group average over one, three, five and 10 years. As a reference, we also compare STS with open-ended peers in the IA Global Equity Income sector – it is ahead of the peer average over one and five years, while trailing over three and 10 years. In terms of risk-adjusted returns, as measured by the Sharpe ratio, STS is in line with the closed-end average over one and three years. Its discount is broadly average, its ongoing charge is lower and no performance fee is payable. Its gearing is in line and its dividend yield is broadly in line with the peer group average.

Exhibit 8: AIC Global Equity Income peer group as at 15 February 2017

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Securities Trust of Scotland	187.2	36.0	40.7	77.2	73.9	1.3	0.1	(3.8)	1.0	No	111	3.5
Blue Planet Investment Trust	22.1	53.3	16.5			1.0	(0.3)	(16.9)	3.9	No	141	6.7
F&C Managed Portfolio Income	53.8	27.4	25.9	66.6		0.4	(0.3)	0.2	1.1	Yes	105	4.1
Henderson International Income	234.8	39.0	50.6	93.8		1.4	0.3	(1.0)	1.0	No	101	3.2
Invesco Perp Select Global Eq Inc	63.3	38.3	48.4	101.8	131.1	1.0	0.2	(2.4)	1.0	Yes	107	3.1
JPMorgan Global Growth & Income	358.6	61.6	67.7	104.6	175.3	2.3	0.6	(6.6)	0.6	Yes	105	2.3
London & St Lawrence	110.8	26.2	24.8	68.5	90.8	0.6	(0.3)	(4.6)	0.7	Yes	100	4.0
Murray International	1,508.1	50.2	48.0	59.2	162.5	2.1	0.2	1.2	0.8	No	112	3.9
Scottish American	442.4	40.5	54.7	72.2	73.2	1.4	0.4	(1.1)	0.9	No	119	3.3
Closed-end fund simple average		41.4	41.9	80.5	117.8	1.3	0.1	(3.9)	1.2		111	3.8
STS rank in sector	5	7	6	4	5	5	6	6	4		4	5
Open-end fund simple average		34.5	42.3	76.8	79.3							

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

There are five directors on the board at STS; all are non-executive and independent of the manager. Chairman, Rachel Beagles, was elected in July 2010 and assumed her current role in July 2016 following the retirement of Neil Donaldson, who had been on the board since STS's inception in 2005. Senior independent director, Andrew Irvine, has been on the board since May 2005. The other three directors and their dates of appointment are: Angus Gordon Lennox (November 2013), Mark Little (October 2014) and John Evans (February 2016). The directors have backgrounds in business, finance and investment management.

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